Office of Chief Counsel
Internal Revenue Service

memorandum

CC:SB:8:LN:3:TL-N-4172-01
FNPanza

date JUL 24 2001

to: Gary Morishita, Group Manager, SB/SE:C:A14:SA:T2:G7 (FE 1504)

from. Edwin A. Herrera, Associate Area Counsel, SB/SE, Laguna Niguel, Group 3
Frank N. Panza, Attorney, SB/SE, Laguna Niguel, Group 3

subject **Request for Advisory Opinion**

Taxpayer: [redacted]
Year: [redacted]
S/L: [redacted]

This memorandum is in response to your June 27, 2001, Request for Advice regarding the taxpayer referenced above. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

CONCLUSION

We have reflected, in the Section headed **QUESTIONS FOR IDR**, the questions we recommend you raise with the taxpayer to help resolve this matter. The Service may not have all of the documents it ought to have in order to do so. [1]

[1] We believe you might already have some of the items we have recommended you ask for in an IDR. However, since your memorandum requesting our advice had only two documents attached to it, i.e., a business card of a tax person at a company named

This memorandum will also address the principal substantive issue raised in the case, i.e., the taxability of certain malpractice insurance proceeds, as well as certain procedural issues, i.e., the appropriate person to execute a Form 872, and the appropriate person to whom to direct any Statutory Notice of Deficiency (SNOD).

For the reasons reflected below, we think that if the relevant proceeds were received in connection with a claim that:

(a) a tax advisor failed to advise [redacted], [redacted]., ([redacted]) or [redacted] [2] of the correct tax consequences of the transaction in which [redacted] was acquired; or

(b) the advice provided regarding the tax consequences of the transaction was incorrect,

any payment an insurance company makes to compensate [redacted] or [redacted] for any liability it might owe will constitute taxable income.

Assuming that:

(1) [redacted] was the company entitled to the malpractice insurance proceeds;

(2) [redacted] was merged out of existence in a taxable transaction when [redacted] acquired it;

(3) pursuant to the applicable state merger law, [redacted] is the legal successor to [redacted]'s assets and liabilities; and,

(4) [redacted] was not a member of an affiliated group of corporations (with a common parent other than itself) filing a consolidated federal income return for a period

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Los Angeles Pacific-Southwest, and a document entitled **PROPOSED RESOLUTION OF [redacted] MERGER ISSUE**, we are not sure what you do and do not have. Consequently, we have reflected what we recommend you ask for, and you can tailor your IDR to take into account those items that already are in your possession.

[2] Any reference to [redacted] in this memorandum, should be deemed made to [redacted], and to any [redacted] affiliate. Further, we do not know the legal name and EIN of [redacted], and would appreciate your furnishing them to us.

> prior to the merger in which the malpractice insurance proceeds are includible in taxable income,

we believe any extension (Form 872) respecting the time within which an assessment might be made against [redacted] for a taxable period ending prior to the merger, and any SNOD asserting that the malpractice insurance proceeds were taxable in a taxable year ending on or prior to the date of the merger, should be sent to [redacted], in its capacity as the legal successor to [redacted].

This memorandum will not address the taxable year in which any such malpractice insurance proceeds might have constituted taxable income. Specifically, it will not address whether those proceeds constituted taxable income in the year the malpractice occurred, the year the malpractice claim was made, the year in which the insurance company agreed to pay the malpractice insurance proceeds, or the year in which those proceeds were received. The answers to those questions will be relevant in determining the entity that will be required to sign any Form 872 extending the period of limitations on assessments of any tax that might be attributable to the malpractice insurance proceeds, and in determining to whom a statutory notice of deficiency (SNOD) asserting that the malpractice insurance proceed were taxable, should be sent.

We will note, however, that if the proceeds constituted income after the date that [redacted] acquired [redacted], the acquiring company will be required to report that income. If the acquiring company was not a member of an affiliated group of corporations filing a federal consolidated income tax return in the year the proceeds were required to be included in its income, it will be the appropriate person to sign a Form 872, and to receive an SNOD. If it was a member of such a group, the common parent of that group would be the appropriate person to sign a Form 872, and to receive an SNOD.

Since answering the questions regarding which company should sign a Form 872, and to whom an SNOD should be issued will be difficult only if the malpractice proceeds constituted [redacted]'s income during a period prior to [redacted]'s acquisition of [redacted], this memorandum will assume, but will not decide, that those proceeds constituted income to [redacted] during such a period. (We think it is unlikely that the malpractice insurance proceeds would have constituted taxable income to [redacted] in a period prior to its

acquisition by [redacted]. However, as stated above, that is not a question that this memorandum will address.)

Finally, you should be aware that we are sending a copy of this advice to our National Office for post-review. We will advise you in the event that the comments our National Office sends us make it necessary for us to revise this advice in any respect.

FACTS

When we met on June 26, 2001, to discuss this issue, we understood you to say that [redacted] filed a federal income tax return in which it indicated that it acquired the stock of [redacted] in a reorganization that was tax-free pursuant to I.R.C. § 368(a)(1)(B). However, in conducting an audit, the revenue agent determined that the acquisition was effected pursuant to a cash merger, i.e., a merger in which the consideration paid to the old [redacted] shareholders was cash. (We do not know whether [redacted] was merged directly into the company that provided the consideration i.e., a direct merger, or into a subsidiary of that company. We also do not know whether [redacted] was acquired in a transaction in which a [redacted] subsidiary was merged into [redacted]. The answers to the questions we suggest you ask in an IDR should clarify how [redacted] was acquired.)

At some undetermined point in time, someone (probably, though not certainly, [redacted]) realized that the acquisition was not a tax-free transaction. It appears that: (a) someone (again, probably, though not certainly, [redacted]) then asserted a malpractice claim against a person who provided tax advice in connection with the transaction; and, (b) that advisor's insurer is prepared to provide, or has already provided, funds to settle that malpractice claim.

We do not know whether [redacted] was a member of a consolidated federal income tax group at the time it was acquired by [redacted] Nor, if it was a member of any such group, do we know whether it was the common parent of that group. Finally, if it was a member of any such group, and was not the common parent of that group, we do not know who that common parent was at the time [redacted] was acquired, and who it might be today.

QUESTIONS FOR IDR

In order to deal effectively with the transaction, the Service's IDR should be designed to generate answers that will clarify what the actual facts were. We believe the following questions will do so.

Please provide:

(1) copies of all of the documents pursuant to which [redacted], or any affiliate of [redacted], acquired [redacted]; and,

(2) copies of all of the documents which relate to the acquisition and which were filed with any governmental authority.

The documents sought in questions (1) and (2) include, but are not limited to, the following:

(a) any letter sent by [redacted] to [redacted] indicating [redacted]'s (or any affiliate of [redacted]'s[3]) intent to acquire [redacted], e.g., any letter of intent executed by [redacted], or any [redacted] affiliate, in connection with its acquisition of [redacted];

(b) any contract pursuant to which [redacted] was obligated to acquire [redacted];

(c) any merger agreement to which [redacted] and [redacted], or any [redacted] affiliate, were parties;

(d) any bill of sale reflecting the transfer of [redacted]'s stock, or of [redacted]'s assets to [redacted], or to any company affiliated with [redacted];

(e) any certificate filed with any governmental authority, including, but not limited to any Secretary of State, relating to [redacted]'s acquisition of [redacted];

(3) copies of [redacted]'s certificate of incorporation at the time it was acquired by [redacted];

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[3] Any reference to [redacted] in this IDR, is made to [redacted], and to any [redacted] affiliate.

(4) copies of the certificate of incorporation of the company that acquired [redacted];

(5) a precise description of the relationship between [redacted] and that acquiring company, if the company that acquired [redacted] was different from [redacted];

(6) copies of any opinions, and any letters or memoranda, provided by any lawyer or any tax professional to [redacted] and/or to [redacted], indicating the expected legal and tax consequences of the acquisition transaction to [redacted], [redacted], and/or [redacted]'s shareholders;

(7) copies of all correspondence relating to the opinions, letters, and memoranda referred to in (6) between [redacted] and/or [redacted], and any person or persons (other than an insurance company or an insurance company representative) with respect to any claim [redacted] and/or [redacted] might have for malpractice against the person providing the relevant opinion, letter, and/or memorandum;

(8) copies of any insurance policy pursuant to which [redacted], FMI, and/or the present or former shareholders of either or both [redacted] and [redacted], are planning to make, or have made, a claim for a malpractice recovery in connection with any advice respecting the expected tax and/or other consequences of the acquisition transaction to [redacted], [redacted], and/or [redacted]'s then shareholders;

(9) copies of any correspondence between or among [redacted], [redacted]'s present or former shareholders, [redacted], (or any person representing any of them), and any insurance company (or any representative of such an insurance company) insuring any person against whom [redacted], [redacted]'s former shareholders, or [redacted], is making any claim for damages for malpractice, in connection with any tax or other advice provided in connection with [redacted]'s acquisition of [redacted];

(10) information regarding whether, during [redacted]'s last taxable year ending prior to its acquisition by [redacted], [redacted] was a member of an affiliated group of corporations filing a

federal consolidated income tax return. If it was, please provide information regarding whether [redacted] was the common parent of that group on the date of its acquisition by [redacted]. If [redacted] was a member of an affiliated group of corporations filing a federal consolidated income tax return, and was not the common parent, please provide the name, EIN, last known address, and telephone number of the common parent of that group at that time, and the name and EIN of the common parent of that group today.

LAW AND DISCUSSION

A. TAXABILITY OF MALPRACTICE INSURANCE RECOVERY

The document you provided to us entitled **PROPOSED RESOLUTION OF [redacted] MERGER ISSUE**, contains a proposal that the Service and [redacted] would enter into a Closing Agreement. That Closing Agreement would provide that "the payment made by the insurance company to compensate for the net amount of [redacted] tax paid is not taxable income to [redacted] or [redacted]." In support of that conclusion the person preparing that document cited Rev. Rul. 57-47, 1957-1 C.B. 23; Concord Instruments Corp. v. Commissioner, T.C. Memo 1994-248; and, Clark v. Commissioner, 40 B.T.A. 333 (1939).

It is possible that the question regarding the taxability of the malpractice insurance proceeds in this case might ultimately be litigated. If it is ever litigated, in our opinion, so long as those proceeds were designed to compensate the recipient for additional taxes it was required to pay on account of the acquisition transaction's being taxable, (as opposed to tax exempt as erroneously advised), the Service will maintain the recovery will be taxable income.

Clark v. Commissioner, supra, is the leading case holding that a tax malpractice insurance recovery did not constitute taxable income.

In Clark, supra, the petitioner was a married individual who, for the 1932 taxable year, could have filed either a joint return or a return as a married person filing separately. His tax counsel advised him to file a joint return. In that taxable year, the petitioner incurred a capital loss. If he and his spouse had chosen to file separate returns, their combined tax liability would have been approximately $20,000.00 less than it was as a

result of filing a joint return. Mr. Clark received a malpractice recovery from his advisor, and excluded that recovery from his income in the year of its receipt.

The Service argued the recovery was a payment of the petitioner's tax by a third party, and thus was taxable income in the petitioner's hands. The Board of Tax Appeals disagreed. It held that amount in question was not income because it constituted compensation for a loss which impaired the petitioner's capital.

In Rev. Rul. 57-47, supra, the Service agreed that a tax malpractice recovery did not constitute taxable income. There, a tax consultant made an error in preparing the relevant taxpayer's federal income tax return, causing the taxpayer to pay more taxes than she would have, had the correct method of filing been employed. Citing Clark, supra, but with no other explanation, the Service held the malpractice recovery (but not interest on the recovery) did not constitute income.

Finally, in Concord Instruments Corp. v. Commissioner, supra, the Tax Court held that a taxpayer was entitled to exclude from income, a malpractice insurance recovery received to compensate the taxpayer for a failure by his tax counsel to file a timely appeal against an adverse court decision. The Court held that the recovery was designed to compensate the petitioner for a loss of capital, and thus, did not constitute income. In a footnote to its Concord Instruments Corp., supra, opinion the Court cited Rev. Rul. 81-277, 1981-2 C.B. 14, where the Service indicated that "Payments by one causing a loss that do no more that restore a taxpayer to the position he or she was in before the loss was incurred are not includible in income." See, Concord Instruments Corp., supra, fn. 19.

In our judgment there is a fundamental distinction between the situations in Clark, supra, Rev. Rul. 57-47, and Concord Instruments, supra, and the situation in this case.

Specifically, in the situations described in Clark, supra, and Rev. Rul. 57-47, supra, the bad advice received by the taxpayer did not address how to structure a transaction in order to minimize its tax consequences, but rather addressed how to report the tax consequences of a transaction that was already completed. That bad advice caused the relevant taxpayer to pay more tax than he would legally have been required to pay, had he reported the relevant transaction appropriately. And in Concord

Instruments Corp., supra, the recovery was received in connection with a procedural mistake an adviser made, and not as a result of mistaken substantive tax advice.

In the instant case, [redacted] entered into a transaction whose tax consequences were fixed, although possibly unexpected as a result of erroneous tax advice that it apparently received.

Lawrence Zelenak, a law professor, published an article entitled, "The Taxation of Tax Indemnity Payments: Recovery of Capital and the Contours of Gross Income," 46 Tax Law Review 381 (Spring 1991). That article is the leading analysis of the tax consequences of receiving payments intended to indemnify a person for additional taxes incurred after the receipt of erroneous tax advice.

In that article, Professor Zelenak articulated the fundamental theory upon which the Service relied in a number of PLRs (cited below), in which it concluded that damages received for erroneous tax advice constituted income, i.e., that a tax indemnity payment should be considered to be income where the taxes that the relevant taxpayer paid were the correct taxes due on the underlying transaction.[4] Professor Zelenak pointed out that in the situation described in one of those PLRs, i.e., PLR 8748072, September 3, 1987, (discussed in greater detail below), the relevant taxpayers could not have legally paid any less tax based on the nontax facts as they actually existed. He concluded that if a taxpayer's tax liability, based on the actual facts, was as low as legally possible, none of the tax he or she pays should be classified as an "excess tax" which effectively invaded the taxpayer's capital. Thus, any indemnification received as a result of erroneous advice regarding the tax consequences of the transaction giving rise to the liability could not constitute a return of capital.

While we believe Professor Zelenak's theory, and the rationale expressed in the PLRs reflected below, are correct, there are other points of view that don't agree. See, Dale Bandy, "Reimbursement for Return Error Can Be Taxable Income To Client,"

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[4] While private letter rulings do not constitute the position of the Service, and may not be cited as precedent, we believe the Service's rationale in the PLRs cited in this memorandum is correct, and helpful to an analysis of the question you posed.

60 Taxation for Accountants 373 (June 1998). Nonetheless, if the facts developed in this case indicate that the recovery is being received on account of erroneous tax advice indicating that the transaction in which [redacted] acquire [redacted] was nontaxable, we believe the tax indemnification payment made on account of that erroneous advice will constitute taxable income.

In the Service's view, expressed in a number of PLRs released in the last 10 years, where a tax advisor provides erroneous advice regarding the tax consequences of a transaction, a malpractice recovery to reimburse the taxpayer for any taxes he or she incurs despite that advice will constitute taxable income. In substance, in those PLRs the Service concluded the taxes the taxpayer was legally obligated to pay were a consequence of the transaction he or she entered into, and not a result a result of any mistake the tax advisor made. Thus, the Service has concluded that the reimbursement of any such tax liability is taxable income, and not simply a return of capital.

In PLR 9833007, May 13, 1998, the relevant taxpayer won a state lottery. His tax professional failed to advise him to maximize his deductible expenses by paying state income tax in the earliest year on his winnings. In ruling that the tax indemnification payment the taxpayer received constituted income, the Service indicated:

> The indemnity payment that you will receive as reimbursement for the economic detriment you sustained is distinguishable from the indemnity payments in Clark and Rev. Rul. 57-47. In Clark, and Rev. Rul. 57-47, the preparers' errors in filing returns or in failing to claim refunds caused the taxpayers to pay more than their minimum proper federal income tax liabilities based on the underlying transactions for the years in question. However, your payment of additional federal income tax was not due to an error made by the attorneys on the return itself but on an omission to provide advice that would have reduced your federal income tax liability. Thus unlike the situations in Clark and Rev. Rul. 57-47, you are not paying more than your minimum proper federal income tax liability based on the transaction for the tax year to which the tax reimbursement relates. Therefore, under section 1.61-14(a) [of the Income Tax Regulations] the indemnity

payment that you receive . . . is includible in your income.

PLR 9833007, supra, is the last in a series of PLRs that look to the same question in determining whether a tax indemnity payment constitutes income, i.e., whether the underlying transaction in connection with which the advice was provided resulted in taxable income to the taxpayer. If it did, and the malpractice recovery simply reimbursed the taxpayer for a tax liability that the taxpayer incurred because he or she followed erroneous advice in entering into the transaction, the Service has concluded that the malpractice recovery constitutes taxable income. See also, PLR 9728052, April 16, 1997, where the Service held that a malpractice recovery received to compensate the taxpayer for erroneous advice regarding who to structure alimony payments constituted income; and, PLR 9743035, July 28, 1997 revoking PLR 9211015, December 12, 1991.

In PLR 9211015, supra, the Service had ruled that a recovery designed to compensate the taxpayer for additional taxes it incurred as a result of failing to satisfy certain diversification requirements prescribed in I.R.C. 851(b) was excludible from income. In revoking that PLR, the Service again indicated that the tax the relevant taxpayer was required to pay was the appropriate tax for the underlying transaction. Therefor, the insurance company's reimbursement of that tax to the taxpayer constituted taxable income. See also, PLR 91200014, February 15, 1991, in which the Service withdrew PLR 8748072, supra, where it had held that a tax indemnification payment was not income where it reimbursed the taxpayer for additional taxes he incurred as a result of a mortgage pool's containing some non-qualified investments.

B. WHICH COMPANY SHOULD EXECUTE A FORM 872 WITH RESPECT TO [redacted] TAX LIABILITIES ARISING IN TAXABLE YEARS ENDING PRIOR TO THE MERGER, AND TO WHOM SHOULD AN SNOD BE ISSUED?

The revenue agent has indicated that the statute of limitations on assessment of [redacted]'s tax liabilities will expire on [redacted]. Insofar as the taxability of the malpractice insurance proceeds are concerned, the expiration of the statute of limitations on assessments against [redacted] will be relevant if the

income from the malpractice insurance proceeds was includible in [redacted]'s income during the period prior to its acquisition by [redacted]. [5]

In a cash merger transaction, where the acquired company is merged directly into the acquirer, for tax purposes, the transaction is deemed to be an asset acquisition by the acquiring company, followed by a deemed liquidation of the acquired company. In that deemed liquidation, the acquired company's shareholders are considered to receive the consideration provided by the acquiring company (or its parent) as a liquidation distribution from the acquired company. See, Rev. Rul. 69-6, 1969-1 C.B. 104, and, Bittker and Eustice, Federal Taxation of Corporations and Shareholders, Seventh Edition, ¶ 12.22[1]. (In our judgment, the same rules would apply where the target is merged into a subsidiary of the acquirer and the target's shareholders receive cash provided by the parent of the acquirer.)[6]

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[5] In this connection, so long as [redacted] was not the surviving company in the merger pursuant to which it was acquired by [redacted], we are assuming the revenue agent would be looking to [redacted] to sign any extension of the statute of limitations if he believed the income arose after the acquisition. Again, we are not addressing the question when that income might have arisen in this memorandum.

[6] If a target is acquired through a merger with a transitory subsidiary set up by the acquirer for purposes of the merger, with the target surviving, the transaction will be treated as a taxable stock purchase. See Bittker and Eustice, supra, ¶ 12.67[2]. In such a case, for tax purposes, the acquired company will simply continue in existence. If it is deemed to have continued in existence, and the income in question is deemed to have arisen before its acquisition, [redacted] will be the appropriate person to execute any Form 872, and to whom to direct any SNOD, so long as it was not a member of an affiliated group of corporations filing a consolidated federal income tax return at the time it was required to include the malpractice insurance proceeds in its income. If it was a member of such an affiliated group at that time, and not the common parent of that group, the common parent of that group would be the appropriate person to sign the Form 872, and to whom to direct the SNOD. If it was the common parent of such a group, is deemed to have continued in existence, and the income in question is deemed to have arisen before its acquisition, again, it will be the appropriate person to sign a From 872, and to receive an SNOD.

Where a cash merger is treated as a sale of assets, the selling company (i.e., the acquired company) will incur a tax liability on its gain on the asset sale. However, because that company will have merged into the acquiring company (i.e., the surviving company) the acquired company will no longer be in existence. Consequently, there is some question regarding the steps the Service would take in order to assert any additional tax due from that company.

Specifically, since the acquired company is no longer in existence, there is some question regarding which company should sign a Form 872 extending the statute of limitations on assessment of any tax liabilities that the acquired company might have incurred prior to its merger into the acquiring company. And there is also some question regarding the identity of the appropriate company to whom the Service should send a statutory notice of deficiency (SNOD). With respect to the latter question, Bittker and Eustice imply that it would be appropriate to send the SNOD to the surviving corporation, apparently because that surviving corporation is a legal successor to the acquired corporation under state law. See Bittker and Eustice, supra, ¶ 12.22[1].

We have found nothing the Service has issued that directly addresses those questions. In proposed Treasury Regulation § 1.1502-77(a)(1)(iii), the Service indicated that for purposes of that section only, the term "successor" means a party that is primarily liable pursuant to applicable law (including, for example, by operation of a federal or state merger statute), for the tax liability of the common parent or any subsidiary of the relevant consolidated group. A proposed regulation does not reflect the position of the Service. Even if it did, however, the definition of successor in that proposed regulation is not directly relevant to the questions arising in this case.

Assuming [redacted] was not a member of a group of corporations filing a consolidated federal income tax return prior to its acquisition, we believe there is no person other the surviving corporation who could sign a Form 872 on its behalf, or to whom such an SNOD could reasonably be sent. So we believe the surviving company would be the appropriate person to execute a Form 872, and to whom such an SNOD should be sent. However, we are asking our National Office's views on those questions in conjunction with our forwarding this memo to that Office for post-review.

If you have any questions regarding this matter, please feel free to telephone Attorney Frank N. Panza at (949) 360-3436.

EDWIN A. HERRERA
Associate Area Counsel
(SB/SE: Area 8)

By: _____
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